

**Testimony before the Senate Committee on Commerce, Science, and Transportation  
Regarding  
S. 2255, a Bill to Extend the Internet Tax Freedom Act through 2006**

Donald Bruce, Assistant Professor  
[dbruce@utk.edu](mailto:dbruce@utk.edu)

and

William F. Fox, Professor  
[billfox@utk.edu](mailto:billfox@utk.edu)

Center for Business and Economic Research  
100 Glocker Building  
The University of Tennessee  
Knoxville, Tennessee 37996-4170  
(865)974-5441 (tel.)  
(865)974-3100 (fax)

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Introduction

Good morning, and thank you for this opportunity to address whether the Internet Tax Freedom Act (henceforth referred to as the Act) should be extended through 2006. Let me begin by stating that we are in agreement with the basic theme of the Act. That taxes should be levied in a nondiscriminatory way is absolutely fundamental.

Our objection to the Act's extension is that it represents the failure to act on an issue of monumental importance. It places us on a policy trajectory that prevents meaningful cooperative action to solve the problems at hand. First, such a policy erodes the ideal of tax neutrality—the notion that decisions to produce or purchase a particular good or service should not be made on the basis of differential tax treatment. Second, extending the Act perpetuates reliance on the Court-determined standard of nexus that is based on physical rather than economic presence. A consequence of this is that future effort toward simplification and improvement of sales and use taxes becomes even more difficult, and state and

local governments lose significant amounts of tax revenue.

### Tax Neutrality

The primary issue in the greater debate is that of tax neutrality. Essentially, the tax treatment of a particular good or service should not depend on how that good or service is obtained for final consumption. Differential taxation affects not only consumer decisions of where to buy, but also business decisions of where to produce. In this electronic world, both sides will go wherever they get the best deal—and taxes can make the difference, thereby disadvantaging many regions of the country and many traditional businesses.

This idea is presumably at the heart of the original Act—*discriminatory* taxes on internet sales should be prohibited. However, nondiscrimination must go in both directions. In other words, the tax treatment of internet sales must not discriminate against local bricks-and-mortar establishments.

To illustrate, consider the following parallel with local infrastructure investments. A city that decides to renovate a downtown street will inevitably subject a number of businesses—and their customers—to tremendous inconvenience. Potential patrons will be less likely to visit these establishments during the construction period, and the businesses may have to close their doors as a result. These businesses probably will not reopen after the completion of the construction.

In a similar manner, the Act represents an investment in the internet as a transaction mechanism. Nonetheless, subsidizing internet firms (through non-taxation) places a direct comparative disadvantage on local retailers, inevitably forcing some of them out of business forever.

### Nexus and Revenue Implications

A key component of the Act is its implicit acceptance of a definition of nexus that is based on physical presence—effectively limiting each state’s ability to enforce collection of use taxes on remote sales. Extending the moratorium through 2006, while delaying any cooperative effort between the Federal

and state governments toward sales and use tax simplification, will only make it more difficult for states to collect sales and use taxes.

Our research shows that revenue losses to state and local governments, while not particularly large in the immediate term, will grow dramatically under the status quo. Admittedly, state and local sales tax bases were already eroding as a result of the growth of all types of remote sales, greater consumption of untaxed services relative to taxed goods, and the continuation of legislated exemptions, long before the development of the internet. E-commerce will only accelerate this historical trend, and will result in an *additional* revenue loss of \$10.8 billion by 2003.

It has been argued in defense of this Act that states have enjoyed strong revenue growth in recent years. It should be noted, however, that this is a cyclical phenomenon—long-term revenue growth is not excessive. Similarly, the robust growth of e-commerce is a result of convenience, price, quality of service, and the like, and cannot be attributed solely to this Act. Taxing remote sales like their local counterparts would certainly not kill the “golden goose.” To be clear, our position is neither for nor against larger government—we are merely advocating the neutral, nondiscriminatory tax treatment of *all* types of commerce such that state and local governments can finance their activities as they see fit.

### Policy Options

The primary question, then, seems to be whether or not the sales tax should be preserved as a source of state and local revenue. Extending this Act will permit the continued erosion of sales and use tax bases due to the expansion of e-commerce, and state and local governments will have no choice but to turn away from our nation’s primary *consumption*-based tax toward higher taxes on *income and wealth*. As it generates nearly one-third of all state tax revenues, we are of the opinion that the sales tax should be

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Donald Bruce and William F. Fox, “*E-Commerce in the Context of Declining State Sales Tax Bases*,” Center for Business and Economic Research, University of Tennessee, April 2000.

preserved, with the following general modifications.

First, Congress should replace the outdated definition of nexus with one that is more in line with the modern economy—nexus should be based on *economic* rather than *physical* presence. Firms that significantly exploit a particular state's market should be expected to withhold sales and use taxes for that state, regardless of whether or not the firm has physical presence.

Second, in exchange for this broader definition of nexus, states should be expected to implement substantial simplification measures. Included in this would be each state's adoption of a single sales and use tax rate and a state-specific definition of the set of taxable goods and services, presumably drawn from a set of uniform product definitions. Whether a bag of honey-roasted peanuts is "food" should be determined by a national standard, while the decision of whether or not it is taxable (and at what rate) should still be left to each individual state.

These simplification measures would, in the process of restoring significant lost revenues, enable a more streamlined and less burdensome collection process for remote vendors. More importantly, production and purchasing decisions would then be based on economically relevant factors rather than on differential sales and use tax treatment.

## Conclusion

It has been said that the sales tax is a dying tax, and that e-commerce is just the thing to push it toward an early grave. Our belief is that e-commerce can provide the incentive for Congress to work with the states to improve our system of consumption taxation, such that sales and use taxes can continue to be stable and significant sources of revenue.

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For a broader discussion of these issues, see William F. Fox and Matthew N. Murray, "The Sales Tax and Electronic Commerce: So What's New?" *National Tax Journal* 50(3): 573-592.